

Practice Management Digest

STRATEGIC PLANNING: KNOW THYSELF — A CASE STUDY

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Editor's note: This article was adapted from a presentation by Michael Webber, Allied AIA, at the joint 2004 AIA-California Council/AIA National Practice Management Knowledge Community Conference in Palm Springs, CA.

Not all projects or clients are profitable. But it may go further than just *individual* projects or clients. It could be that certain project or client *types* are not profitable for your firm. Or the converse could be true. Certain project or client types — or projects of a certain size, or in a certain geographic areas — are incredibly profitable for your firm. But do you know which ones are? Regardless of the project-based accounting software you use, your firm already has this information.

Consider a firm with \$10.5 million of **Net Revenues**. This could be the Net Revenues of a small or mid-size firm for two, or three years, or it could be a larger firm for one year. Regardless, on these Net Revenues the firm realized 12.5% profit, and a **Billing Multiplier** of almost 3.0. (Remember the old rule of thumb of 3? ["If I can bill my people out at 3 times what I pay them, we should be able to make money."] It still works — and 3.00 is still the most common 'target' multiplier in the industry.) Right there, the firm might have said, "Hey, looks great! We are already above average. Why do we have to look any further?" Why? Because there is some *very* interesting — and strategically important — information in the details behind those numbers. Wait until you see some of the information this case study uncovers.

Out of the numerous projects that made up this Net Revenues-base, the firm identified seven basic *project* types that it designs, and six basic *client* types for whom it works.

All the projects were sorted by these project and client types, and total Net Revenues and a Billing Multiplier calculated for each subgroup, or market segment, leading to **Exhibit 1**.

Net Revenue is *Total Revenue* minus *all Direct Expenses*. Direct expenses include consultants, printing, testing, travel, etc., expenses directly related to a project— everything but labor. Net Revenue is what remains to cover *your* firm's salaries, and overhead, and produce *your* profits.

A **Billing** (also called Net) **Multiplier** is Net Revenue divided by Direct Labor. In other words, for every \$1 you pay someone to work on a project, how many \$s do you get? A Billing Multiplier can be calculated for every project.

An **Overhead Rate** is *all Overhead* (also called Indirect) Expenses, including Indirect Labor, divided by Direct Labor. An OH Rate is \$s of OH expenses per \$1 of Direct Labor. A firm's overall Billing Multiplier must be greater than 1 + its OH Rate in order to make a profit.

Exhibit 1									
Project Type	A	B	C	D	E	F	G	Total Net Revenue	% of Total Net Revenue
Client Type								Billing Multiplier	
I	\$158,607 <i>1.87</i>				\$922,577 2.73	\$322,856 3.67		\$1,404,040 2.75	13%
II	\$231,007 2.53	\$263,709 1.97		\$208,227 2.13				\$702,943 2.18	7%
III			\$2,336,783 3.69			\$1,015,150 4.85		\$3,351,933 3.98	32%
IV		\$1,026,998 2.08		\$1,223,477 3.51	\$212,680 2.77	\$140,531 3.94		\$2,603,686 2.73	25%
V	\$592,893 2.86	\$557,188 2.54	\$210,893 2.00			\$254,151 2.70	\$578,983 2.63	\$2,194,108 2.59	21%
VI							\$244,555 3.59	\$244,555 3.59	2%
Total Net Revenue	\$982,507	\$1,847,895	\$2,547,676	\$1,431,704	\$1,135,257	\$1,732,688	\$823,538	\$10,501,265	
Billing Multiplier	2.56	2.18	3.45	3.21	2.74	4.06	2.86	2.96	
% of Total Net Revenue	9%	18%	24%	14%	11%	16%	8%	100%	

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Exhibit 1 shows the Net Revenues generated, and Billing Multiplier realized from each Project/Client subgroup. The Billing Multipliers are color coded to indicate whether it is below average, about average, or above average. Subtotals and % of Total Net Revenues also are included for each Project and Client Type.

By *Project* Type, the firm had a balanced basis of work, with each type accounting for about 10% (Project Types A & G) to 25% (Project Type C) of the firm's Net Revenues. But look at the variances among the Billing Multipliers — from about a 2.2 for Project Type B to over a 4.0 for Project Type F! More on the importance of this later, but suffice it for now to say that there is a *major* difference in how much profit each of these Project Types contributed to the firm's bottom-line.

By *Client* Type, about 80% of the firm's net revenues came from just three of these, Client Types III, IV & V). But, again, there is a Billing Multiplier spread from about 2.2 for Client Type II to, again, a 4.0 for Client Type III. Yes! The firm earned a Billing Multiplier of almost 4.0 on Client Type III, from which it also realized 32% of its Net Revenues!

Let's go a step further and look at Operating Profit by subgroup. Yes, you can do that, too. Remember that a Billing Multiplier has as its denominator Direct Labor. So does your **Overhead Rate**. This firm had an OH Rate of 160%. Therefore, by however much the Billing Multiplier exceeds—or doesn't exceed—

2.60 (1 + 160%) determines how much Operating Profit—or Loss—the firm realized from each subgroup. **Exhibit 2** has the same layout as Exhibit 1, but with Operating Profits instead of Net Revenues, and the *difference* between its Billing Multiplier and its breakeven point (1 + its OH Rate) instead of the Billing Multiplier.

Exhibit 2									
Project Type	A	B	C	D	E	F	G	Total Oper Profit	% of Total Operating Profit
Client Type								Bling Mult \$ Breakeven	
I	(\$61,916) (0.73)				\$43,932 0.13	\$94,130 1.07		\$76,146 0.15	6%
II	(\$6,391) (0.07)	(\$84,333) (0.63)		(\$45,947) (0.47)				(\$136,672) (0.42)	(11%)
III			\$690,269 1.09			\$470,946 2.25		\$1,161,215 1.38	91%
IV		(\$256,750) (0.52)		\$317,198 0.91	\$13,053 0.17	\$47,795 1.34		\$121,296 0.13	9%
V	\$53,899 0.26	(\$13,162) (0.06)	(\$63,268) (0.60)			\$9,413 0.10	\$6,604 0.03	(\$6,513) (0.01)	(1%)
VI							\$67,440 0.99	\$67,440 0.99	5%
Total Operating Profit	(\$14,409)	(\$354,246)	\$627,002	\$271,251	\$56,985	\$622,288	\$74,045	\$1,282,917	
Bling Mult \$ Breakeven	(0.04)	(0.42)	0.85	0.61	0.14	1.46	0.26	0.36	
% of Total Oper Profit	(1%)	(28%)	49%	21%	4%	49%	6%	100%	

Overhead Rate = 160%

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In Exhibit 2, let's look at Client Type III again. Projects from this one Client Type, from which the firm generated 32% of its business, generated *over 90%* of the firm's Operating Profits! This is strategic information! Guess who I am inviting first to the next client party! Guess who I am going to develop an entire marketing plan around! Guess whose industry I am going to learn inside and out! Guess whose industry our people are going to learn inside and out! Guess whose associations I am going to join and become active in!

Let's go back to *Project Type* again. As discussed in Exhibit 1, there was a fairly even spread of Net Revenues from each project type. But look at Exhibit 2. By Operating Profit, Project Types C & F *each* generated 49% of the firm's Operating Profits, and D generated 21%.

Wait a minute?! 49% + 49% + 21% = 119%! How is that possible? From Project Type B, the firm *lost* 28% of its Operating Profits — over \$350,000! This firm had Operating Profits of almost \$1.3 million — but it *might* have made over \$1.6 million just by *breaking even* on type B projects! Similarly, there is *Client*

Type II, whose projects lost 9% of the firm's Operating Profits, almost \$140,000. This *also* is strategic information!

Unfortunately, this also is where I must pause in my analysis. As a 'bean counter', I cannot tell you why these losses occurred. Nor can I tell you why other segments made so much money. (Well, actually, I frequently can, at least by asking questions: Was it the fees? Was it the execution of the projects? Was it the PM or team on the projects? Was it client or project requirements? No, that analysis has to come from managers and professional staff of the firm.)

But your 'bean counters' can provide you with all the information needed to conduct this same type of performance review. Regardless of the accounting software you use, any project-based system keeps financial information at the project level. The question is, "Are you using it?"

The strategic part of the analysis comes from a 'post mortem' review of each of the underlying projects in a 'surprise' (a good or bad result) subgroup. Each individual subgroup had several individual projects underlying its results — it is usually *not* just one project inducing the result. Managers and professional staff of the firm should be able to figure out the reasons for each and every 'surprise'. They know what the firm is, and is not, good at. They know where fees are difficult to negotiate. They know! They just may not *realize* they know.

Here are *some* of the strategic questions:

- At what are we financially successful? Why? With whom are we financially successful? Why?
- If financially successful, is it our design, our production, our client relations? Can we expand on this? How? Can we take advantage of this. How? What other client types have similar project needs?
- If not financially successful, why? Can we correct it, at least to the point of breaking even? How? Do we really need to provide this project type (service)? Why? Do we really need the business of those clients? Why?
- On what is our reputation based? Why? At what are we creatively good? Why? Are we financially successful at this, too? Why (or, why not)?

Can a firm just get out of a money-losing area? The answer, of course, is yes and no. As mentioned, the firm has Client Type II that provides only 7% of Net Revenues, but, from those projects, the firm lost almost \$140,000. Work for Client Type II includes three separate Project Types. One of those, Project Type B, always under-performs, regardless of the Client Type. Type A projects for Client Type II essentially break even. Type D projects *only* under-perform for Client Type II; Type D projects for Client Type IV are very profitable. Is this a new, developing client-market that can be profitable? Is the firm trying

to 'buy' its way into this market (a dangerous strategy)? If the firm cannot see at least breaking even for this Client Type, at a minimum at least quit soliciting new clients of this type.

What about Project Type B? Those projects comprise almost 18% of the firm's business. Could (or would) a firm just walk away from almost one-fifth of its business? Other Project Types for Client Type IV are very profitable. Other Project Types for Client Type V are basically breakeven. What are the reasons for the losses for *this* Project Type?

Choosing in which markets to practice is a major part of strategic planning — and a firm *can* choose to stay in a financially unprofitable market. That decision is up to you. *It's your firm*. My only message is that you already have information in your accounting system that you can use to learn and understand how and where you are doing poorly or well. My advice is just to make sure you use it in your decision making. The first step in strategic planning is "*Know Thyself*".

Mike Webber was CFO of a 100+ person, multi-office A/E firm, and is now President of [And Managers Know Why](#) (www.amkw.com), a financial and operations consultant to A/E firms. He also was a member of the Planning Committee for the 2004 PMKC Conference, at which he gave this presentation. Questions may be addressed to him at mawebber@amkw.com.